Supreme Court, U. S.
FILED
NOV 10 1977
MICHAEL RODAK, JR., CLERK

No. 76-1359

In the Supreme Court of the United States

OCTOBER TERM, 1977

BANKERS TRUST COMPANY, PETITIONER

v.

SAMUEL MALLIS AND FRANKLYN KUPFERMAN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

WADE H. McCREE, Jr.,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

HARVEY L. PITT,
General Counsel,
PAUL GONSON,
Associate General Counsel,
JACOB H. STILLMAN,
Principal Assistant General Counsel,
JAMES E. BOWEN,
Special Counsel,
SUE H. AUERBACH,
Attorney,
Securities and Exchange Commission,
Washington, D.C. 20549.

INDEX

	Page
Interest of the Securities and Exchange Commission	1
Statement	2
Summary of argument	7
Argument	11
A pledge of securities as collateral for a loan is a "sale" under Section 10(b) of the Securities Exchange Act of 1934 and the Commission's Rule 10b-5 thereunder	11
A. The definition of "sale" in the Securities Exchange Act of 1934 covers a pledge of securities as collateral for a loan	11
B. The antifraud provisions of the Securities Exchange Act of 1934 were intended to cover fraud in connection with the pledge of securities as collateral for a loan	14
C. The holding of the court of appeals that a pledge is a sale is not inconsistent with *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723	30
Conclusion	35

CITATIONS

Cases:

Affiliated Ute Citizens v. *United States*, 406 U.S. 128	13, 15
American Bank & Trust Company v. *Joste*, 323 F. Supp. 843	24
Birnbaum v. *Newport Steel Corp.*, 193 F. 2d 461, certiorari denied, 343 U.S. 956	7
Blue Chip Stamps v. *Manor Drug Stores*, 421 U.S. 723	7, 10, 30–34
Cecil B. De Mille Productions v. *Woolery*, 61 F. 2d 45	22–23
Coffee v. *Permian Corp.*, 434 F. 2d 383, certiorari denied, 412 U.S. 920	20
Conley v. *Gibson*, 355 U.S. 41	3
Crane Company v. *Westinghouse Air Brake Company*, 419 F. 2d 787, certiorari denied, 400 U.S. 822	20
Dasho v. *Susquehanna Corp.*, 380 F. 2d 262, certiorari denied *sub nom. Bard* v. *Dasho*, 389 U.S. 977	19, 20, 21

249-900-77——1

Cases—Continued

	Page
Dopp v. *Franklin National Bank*, 374 F. Supp. 904	29
Ernst & Ernst v. *Hochfelder*, 425 U.S. 185	29
Heit v. *Weitzen*, 402 F. 2d 909, certiorari denied 395 U.S. 903	18–19
Herpich v. *Wallace*, 430 F. 2d 792	20
Herzfeld v. *Laventhol, Krekstein, Horwath and Horwath*, 540 F. 2d 27	16
Hooper v. *Mountain States Securities Corp.*, 282 F. 2d 195, certiorari denied, 365 U.S. 814	20, 26
Investment Properties International, Ltd. v. *I.O.S., Ltd.*, [1970–1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,011	27
Iroquois Industries, Inc. v. *Syracuse China Corp.*, 417 F. 2d 963	18
J. I. Case Co. v. *Borak*, 377 U.S. 426	2
Knauff v. *Utah Construction & Mining Co.*, 408 F. 2d 958, certiorari denied, 396 U.S. 831	20, 21
Lawrence v. *Securities and Exchange Commission*, 398 F. 2d 276	14, 20
Mader v. *Armel*, 402 F. 2d 158, certiorari denied *sub nom. Young* v. *Mader*, 394 U.S. 930	20
McClure v. *First National Bank of Lubbock, Texas*, 497 F. 2d 490, certiorari denied, 420 U.S. 930	9, 25–27
Mills v. *Electric Auto-Lite* Co., 396 U.S. 375	2
Mitchell v. *Texas Gulf Sulphur Company*, 446 F. 2d 90, certiorari denied, 404 U.S. 1004	16
Radzanower v. *Touche Ross & Co.*, 426 U.S. 148	30
Rosen v. *Dick*, [1974–1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,786	27
Sanders v. *John Nuveen & Co., Inc.*, 463 F. 2d 1075	13
Sante Fe Industries, Inc. v. *Green*, 430 U.S. 462	28
Securities and Exchange v. *Capital Gains Research Bureau*, 375 U.S. 180	15
Securities and Exchange Commission v. *Dolnick*, 501 F. 2d 1279	23, 24
Securities and Exchange Commission v. *Guild Films Co.*, 279 F. 2d 485, certiorari denied *sub nom. Santa Monica Bank* v. *Securities and Exchange Commission*, 364 U.S. 819	24–25
Securities and Exchange Commission v. *International Chemical Development Corp.*, 469 F. 2d 20	25

Cases—Continued

	Page
Securities and Exchange Commission v. *National Bankers Life Insurance Co.*, 334 F. Supp. 444, affirmed, 477 Fd. 2d 920	25
Securities and Exchange Commission v. *National Securities, Inc.*, 393 U.S. 453	8, 12, 13, 14, 20, 21
Scheuer v. *Rhodes*, 416 U.S. 232	3
Schoenbaum v. *Firstbrook*, 405 F. 2d 215, certiorari denied *sub nom. Manley* v. *Schoenbaum*, 395 U.S. 906	20
Smallwood v. *Pearl Brewing Co.*, 489 F. 2d 579, certiorari denied, 419 U.S. 873	20
Spector v. *L Q Motor Inns, Inc.*, 517 F. 2d 278, certiorari denied, 423 U.S. 1055	20
Superintendent of Insurance v. *Bankers Life & Casualty Co.*, 404 U.S. 6	19, 26, 28
Swanson v. *American Consumer Industries, Inc.*, 415 F.2d 1326	21
Tcherepnin v. *Knight*, 389 U.S. 332	8, 13, 14
Travis v. *Anthes Imperial Ltd.*, 473 F. 2d 515	20
United States v. *Gentile*, 530 F. 2d 461, certiorari denied, 426 U.S. 936	9, 17, 24, 27
Vine v. *Beneficial Finance Co.*, 374 F. 2d 627, certiorari denied, 389 U.S. 970	20
Zabriskie v. *Lewis*, 507 F. 2d 546	16
Statutes, regulations and rules:	
Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. 77a *et seq*	12
Section 2(3), 15 U.S.C. 77b(3)	13
Section 2(11), 15 U.S.C. 77(b)(11)	24
Section 3(a)(2), 15 U.S.C. 77c(a)(2)	30
Section 4(1), 15 U.S.C. 77d(1)	24
Section 17a, 15 U.S.C. 77q(a)	24
Section 17(c), 15 U.S.C. 77q(c)	30
Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. 78a *et seq.*:	
Section 3(a)(13), 15 U.S.C. 78c(a)(13)	11
Section 3(a)(14), 15 U.S.C. 78c(a)(14)	11
Section 10(b), 15 U.S.C. 78j(b)	*passim*
Section 16(a), 15 U.S.C. 78p(a)	27
Public Utility Holding Company Act of 1935, Section 2(a)(23), 49 Stat. 809, 15 U.S.C. 79b(a)(23)	13

Miscellaneous:	Page
12 C.F.R. 221.3(q)	22
17 C.F.R. 240.10b-5	*passim*
17 C.F.R. 240.16a-6	27
121 Cong. Rec. 10733 (1975)	15
Hearings on Organized Crime—Stolen Securities, before the Permanent Subcommittee on Investigations of the Senate Committee on Government Operations, 92d Cong., 1st Sess. (1971)	15
Hearings on Organized Crime—Securities: Thefts and Frauds, before the Permanent Subcommittee on Investigations of the Senate Committee on Government Operations, 93d Cong., 1st Sess. (1975)	15
1 Loss, *Securities Regulation* (2d ed. 1961)	25
S. Rep. No. 47, 73d Cong., 1st Sess. (1933)	23
Uniform Commercial Code (A.L.I. Official Draft 1952):	
Section 1-201 (32)	21
Section 3-302 (4)	21
Section 3-302 (Comment 5)	22

In the Supreme Court of the United States

OCTOBER TERM, 1977

No. 76-1359

BANKERS TRUST COMPANY, PETITIONER

v.

SAMUEL MALLIS AND FRANKLYN KUPFERMAN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

It is important to the Securities and Exchange Commission that a pledge of securities as collateral for a loan be construed as a "sale" of those securities under the antifraud provisions of the federal securities laws, so that civil and criminal enforcement proceedings may continue to be brought where fraud is committed in connection with such pledges and so that, as here, the victim of the fraud may maintain an action for damages. The Commission has successfully brought civil proceedings, and there has been at least one successful criminal prosecution, based upon fraud committed in connection with a pledge of securities. Private rights of action are an important aspect of the

enforcement of the federal securities laws, providing a "necessary supplement" to the enforcement actions of the Commission. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 382; *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432.

The Commission is concerned about the scope of the antifraud provisions of the federal securities laws and the injury to investors it believes would result if the Court adopted the restrictive interpretation of those provisions that petitioner and the *amicus curiae* New York Clearing House Association urge. For the reasons that follow, the Commission submits that a pledge of securities as collateral for a loan is a "sale" under Section 10(b) of the Securities Exchange Act of 1934 and the Commission's Rule 10b-5 thereunder.

STATEMENT[1]

In this private action alleging a violation of antifraud provisions of the federal securities laws, respondents Samuel Mallis and Franklyn Kupferman claim that petitioner Bankers Trust Company ("Bankers Trust") fraudulently induced them to accept from third parties certain shares of stock as collateral for a loan, even though Bankers Trust knew the stock was worthless.

In February, 1972, Jack Arnold and John Fowler, as co-venturers, agreed to purchase from Jerome Kates and Judith Kates 40,384 shares of common

[1] Since the district court dismissed the complaint on the ground that respondents lacked standing to maintain the suit, the respondents' allegations are deemed to be true for purposes of this Court's review, and should be construed in a light most favorable to the respondents. See, *e.g.*, *Conley* v. *Gibson*, 355 U.S. 41, 45-46; *Scheuer* v. *Rhodes*, 416 U.S. 232, 236.

stock of Equity National Industries, Inc. ("Equity National") (App. 16, 23-25).[2] The Kateses previously had pledged the stock to petitioner Bankers Trust as collateral for a $50,000 loan, of which some $45,000 was outstanding at the time of the purchase agreement (App. 56-57). The Kateses intended to redeem the stock from Bankers Trust by repaying the loan with the proceeds received from the sale of the stock to Arnold and Fowler (App. 59-60).

Arnold and Fowler arranged to obtain the funds for the purchase by borrowing $156,000 from respondents Mallis and Kupferman. Arnold and Fowler agreed to repay them $156,000, plus a $50,000 fee, within 30 days. To secure this loan, Arnold and Fowler agreed to pledge the Equity National stock to Mallis and Kupferman (App. 49).

The certificates for the Equity National stock (in Bankers Trust's possession as collateral for the loan

[2] "App." refers to the appendix in this Court.

Following the events leading to this suit, but before this suit was brought, respondent Mallis filed an action in the New York Supreme Court against petitioner Bankers Trust, the Kateses, Fowler, Arnold, Equity National and others (App. 63-76). The affidavits and pleadings in that action were incorporated by reference in Bankers Trust's affidavit in support of summary judgment (App. 53) and hence were before the district court and are included in the appendix filed in this Court. The state court action was dismissed before the present suit was filed (App. 88-92).

to the Kateses) stated that the shares were subject to an escrow agreement between Equity National and the Kateses. The agreement permitted Equity National to cancel the shares if a corporation it had acquired from the Kateses in a merger failed to achieve a specified level of earnings within a specified time (App. 44–45).

In March and April 1971 (a year prior to the present transaction), Equity National wrote to Bankers Trust, recalling the shares for cancellation (App. 95–98). Bankers Trust refused to return the shares (Br. App. 53).[3]

A closing on the transaction here was held on March 3, 1972, at the offices of Bankers Trust. Arnold and Fowler, the Kateses, and a representative of Mallis and Kupferman attended it (App. 10, 59, 79). Jerome Kates there delivered to Arnold, at the latter's request, an affidavit stating that, notwithstanding the legend on the Equity National shares, the stock had been released from the escrow agreement and was freely negotiable (App. 75). This representation by Kates, however, was untrue and Bankers Trust knew it was untrue (App. 110). In fact the stock was void and worthless (App. 68, 75–76, 135). Bankers Trust, which was anxious that the Kateses should sell the stock and so obtain funds to repay the loan (App. 68), either remained silent or affirmatively stated that the stock was no longer subject to the restrictive legend.[4]

[3] "Br. App." refers to the Appendix to the petitioner's brief.

[4] The pleadings and supporting affidavits are unclear whether Bankers Trust's representative remained silent or actually misrepresented the status of the stock. The original complaint alleged, as against Bankers Trust, only that it violated the Securities Act of 1933 and contained no allegation of fraud and no claim concerning Bankers Trust's actions at the closing (App. 11; note 5, *infra*). The earlier state court action, whose pleadings and supporting documents were before the district court, see note 2, *supra*, alleged that Bankers Trust's role in the fraud was that it "remained silent" (App. 68, 75).

An affidavit of Mallis and Kupferman submitted to the district court in opposition to the motion to dismiss stated that Bankers Trust "withheld vitally material information from us and our representatives and, as we are informed, actually misrepresented that the securities in question were genuine when in fact they were not" (App. 110). The motion to amend the complaint to include a Section 10(b) and Rule 10b–5 claim against Bankers Trust (see p. 6, *infra*) was made "[d]uring the course of proceedings in the district court" (App. 158). The court described the claim as alleging that Bankers Trust "orally assert[ed]" that the certificates were no longer subject to the escrow agreement (App. 135). The court of appeals likewise stated that the theory of the claim was that Bankers Trust "knowingly misrepresented" that the certificates were no longer subject to the escrow agreement (App. 159).

We will refer herein to Bankers Trust's conduct at the closing as "misrepresentation." Affirmance by this Court of the court of appeals' judgment will merely allow Mallis and Kupferman to amend their complaint to allege a cause of action under Section 10(b) and Rule 10b–5; it would not amount to a ruling that Bankers Trust affirmatively misrepresented any fact or that simple nondisclosure alone would be a violation of Section 10(b) and Rule 10b–5 on the facts of this case. See App. 165.

249-800-77——2

Upon Arnold's receipt of the affidavit, Mallis' and Kupferman's agent made out at least two checks totalling $156,000 and handed them to the Kateses, who in turn endorsed to Bankers Trust one such check for $45,000 as the amount due on their loan (App. 60). Bankers Trust thereupon returned the shares, which it had held as collateral, to the Kateses, who immedi-

ately transferred them to Arnold and Fowler (App. 157–158). Shortly after the closing, Arnold and Fowler delivered the shares to Mallis and Kupferman, who, in accordance with their prior agreement, were to hold them as pledgees (App. 71, 76, 158).

Arnold and Fowler defaulted on their agreement to repay Mallis and Kupferman, who then discovered that the securities they held as collateral were void. Mallis and Kupferman instituted the present suit in the United States District Court for the Southern District of New York against Bankers Trust and others (App. 6). The allegations against Bankers Trust in the complaint—allegations not involving fraud[5]—were later abandoned (App. 156), and the respondents sought to amend the complaint to assert a claim that Bankers Trust had violated Section 10(b) of the Securities Exchange Act of 1934 and the Commission's Rule 10b–5 thereunder by representing that Kates' affidavit was true (App. 159). See note 4, *supra*.

On the basis of pleadings and affidavits in a similar state court action incorporated into the present case (see note 2, *supra*), the district court dismissed the claim against Bankers Trust for lack of jurisdiction

[5] Mallis and Kupferman alleged that Bankers Trust violated the "Securities Act of 1933" by accepting the Equity National stock as collateral for the loan to the Katems and by later transferring the stock to Mallis and Kupferman "or their nominee." Mallis and Kupferman did not specify which sections of the Securities Act of 1933 allegedly prohibited these transactions (App. 10–11).

over the subject matter and failure to state a claim upon which relief could be granted (App. 137).[6] The court also denied Mallis' and Kupferman's motion to amend their complaint to assert a claim under Section 10(b) and Rule 10b–5, holding that, as pledgees, they were not "purchasers" of the Equity National stock "within the requirement of the Birnbaum doctrine"[7] and could "not state a claim entitling relief under Rule 10b–5 * * * since no purchase or sale was involved." The court rejected the claim that a pledge of stock is a sale for purposes of Section 10(b) and Rule 10b–5 (App. 134).

The court of appeals reversed the dismissal and remanded with directions to allow Mallis and Kupferman to amend their complaint to assert a claim under Section 10(b) and Rule 10b–5. The court held that, as pledgees, they had standing to sue under Section 10(b) and Rule 10b–5, since the pledge constituted a sale under the antifraud provisions of the Securities Exchange Act (App. 165).

SUMMARY OF ARGUMENT

The Securities Exchange Act of 1934 defines a "sale" to "*include* any contract to sell *or otherwise*

[6] To finance the transaction, Mallis and Kupferman borrowed $156,000 from the Franklin National Bank (App. 7–8), which is now insolvent. The district court dismissed their claims against that bank and its successors (App. 6–9, 131–134), and the court of appeals affirmed (App. 160–162). Those claims are not before this Court.

[7] *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (C.A. 2), certiorari denied, 343 U.S. 956; see *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 749.

dispose of" (emphasis supplied). We submit that this broad language includes a pledge, as does the companion definitional section of the Securities Act of 1933, which defines "sale" to "include every contract of sale or disposition of a security or interest in a security, for value." "[T]he omission of the [latter] term • • • provides no basis for concluding that Congress intended to exclude" a pledge from the 1934 Act's coverage. Cf. *Tcherepnin* v. *Knight*, 389 U.S. 332, 344.

Because of the generality of the definition of "sale" in the 1934 Act, the primary focus in determining whether a particular transaction constitutes a sale within the meaning of Section 10(b) is not on the definition but on the broader issue whether the "alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule" (cf. *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 467).

Fraud in the pledging of securities was meant to be forbidden by Section 10(b) of the Act and Rule 10b–5, just as fraud is prohibited by those provisions where there is an outright sale. In both cases the recipient of securities is induced to part with money in reliance on the value of the securities and in both cases he is vulnerable to fraud by the party transferring the stock to him. The recipient's basic inquiry is the same in each case: whether the value of the stock justifies committing the recipient's capital in reliance thereon. In each case he is induced to acquire a significant interest in the stock in return for the outlay of

capital. "In effect, the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as the indisputable basis for statutory regulation of securities transactions." *United States* v. *Gentile*, 530 F. 2d 461, 467 (C.A. 2), certiorari denied, 426 U.S. 936. Protection against fraud should not be relaxed merely because the pledgee's interest is not a permanent one. The argument that the pledgee has the right to seek repayment from the pledgor's other assets if the pledgor defaults ignores the very purpose of collateral—to enable the lender to obtain repayment of the loan without having to look to the borrower's other assets. The presumed value of the Equity National stock here induced Mallis and Kupferman to make the loan to Arnold and Fowler.

Whether a pledge is considered a purchase under state law is not determinative of the scope of protection of the federal securities laws, but in any event pledges have been treated as sales under the Uniform Commercial Code and state blue sky laws. Federal courts as well have repeatedly held that a pledge of securities is a sale under both the Securities Exchange Act of 1934 and the Securities Act of 1933. *McClure* v. *First National Bank of Lubbock, Texas*, 497 F. 2d 490, 495 (C.A. 5), certiorari denied, 420 U.S. 930, stated that "a pledge of securities can constitute a 'sale' in some cases," but concluded that "the pledge was not a sale in the circumstances of this case." That narrow holding was erroneous, however, because it wrongly assumed that Section

10(b) and Rule 10b–5 reach only transactions which affect the securities industry, and because it concluded that fraud could be actionable only if the pledgee foreclosed on the collateral.

Affirmance of the judgment below would not intrude on state law nor would it subject the federal courts to a plethora of litigation, as petitioner fears. This case involves a charge of fraud similar to that which the Act and the Rule have been recognized as prohibiting for many years, and a pledgee in a 10b–5 action would still have to prove all elements of the offense, not simply that a pledge took place, in order to recover.

The holding of the court of appeals is not inconsistent with *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723. *Blue Chip* held that an offeree of stock who decided not to purchase could not later maintain that its decision not to act was fraudulently induced by the offeror. Here the situation is reversed. Mallis and Kupferman allege that Bankers Trust's fraud induced them to take affirmative action—to make a substantial loan—which they would not otherwise have taken. The dangers which *Blue Chip* foresaw in the context of rejected offers to sell do not apply to this case, since a pledge by its nature is a transaction subject to proof very much like an outright sale. Claims of fraud in the pledge of securities present factual issues of the type that courts and juries customarily have been deciding in securities fraud cases for years.

ARGUMENT

A PLEDGE OF SECURITIES AS COLLATERAL FOR A LOAN IS A "SALE" UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND THE COMMISSION'S RULE 10b–5 THEREUNDER

A. The definition of "sale" in the Securities Exchange Act of 1934 covers a pledge of securities as collateral for a loan.

Section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. 78j(b), makes it "unlawful for any person * * * [t]o use or employ, in connection with the purchase or sale of any security * * * any manipulative or deceptive device or contrivance in contravention of such rules * * * as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." The Commission's Rule 10b–5, 17 C.F.R. 240.10b–5 (Pet. Br. 40–41), generally prohibits fraud or misrepresentation "in connection with the purchase or sale of any security." The Act itself attempts no all-encompassing definition of either "purchase" or "sale," but provides that "purchase" "include[s] any contract to buy, purchase or otherwise acquire," and that "sale" "include[s] any contract to sell or otherwise dispose of." Section 3(a)(13), (14), Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(13), (14) (Pet. Br. 40).

The definitional sections of the Securities Exchange Act of 1934, although "for the most part unhelpful,"

"do indicate the breadth of the statutory terms by using the definitional word 'include' and by including within the definitions contracts 'to buy, purchase, or otherwise acquire' and 'to sell or otherwise dispose of' securities" (*Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 466, 467, n. 8). The word "include" indicates that the listed categories are not exclusive, and the words "or otherwise acquire" and "or otherwise dispose of" show that the statute applies to transactions in addition to those the words "buy" or "sell" directly cover.

When the owner of securities pledges them as collateral for a loan, he is "disposing of" these securities. The disposition initially is only temporary, until the loan has been repaid. It may become permanent, however, if the pledgor defaults on the loan and the lender forecloses on the collateral. There is nothing in the statute requiring that for there to be a sale the disposition must be complete and permanent. It is enough to trigger the application of the antifraud provisions that the owner of securities has disposed of an interest in them in a transaction in which the person acquiring the interest is likely to be influenced by misrepresentations or failure to disclose material facts by the owner.

This is confirmed by the companion definitional section of the Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. 77a *et seq.*, which also contains antifraud provisions covering sales of securities. That section defines "sale" to "include every contract of sale or disposition of a security or interest in a security, for value." 15 U.S.C. 77b(3). When a borrower pledges securities with a lender as collateral for a loan, he is disposing of an "interest in a security, for value." Although the definition of "sale" in the 1934 Act does not contain the words an "interest in a security," "the omission of the term * * * provides no basis for concluding that Congress intended to exclude" a pledge from the 1934 Act's coverage[8] (*Tcherepnin* v. *Knight*, 389 U.S. 332, 344; see also, *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151; *Sanders* v. *John Nuveen & Co., Inc.*, 463 F. 2d 1075, 1078 (C.A. 7)).[9]

[8] Bankers Trust (Br. 20) and the Clearing House (Br. 10) point to the fact that the Public Utility Holding Company Act of 1935, unlike the Securities Exchange Act, expressly includes a "pledge" within the definition of "sale" (Section 2(a)(23), 49 Stat. 809, 15 U.S.C. 79b(a)(23)). But this fact does not, as they contend, demonstrate that Congress intended to exclude pledges from the definition of sale in the Securities Exchange Act. In enacting the Holding Company Act, Congress imposed detailed substantive regulation on the disposition of securities, and necessarily gave particular attention to the various means by which a disposition could occur and, accordingly, specifically mentioned a pledge. In the Securities Exchange Act, on the other hand, Congress was concerned with the prevention of fraud in securities transactions generally, and there was no need to enumerate the variety of forms a disposition could take. It chose instead to adopt broad provisions against fraud by those who "dispose of" securities. See *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*, 393 U.S. at 466, 467 n. 8; *Tcherepnin* v. *Knight*, *supra*, 389 U.S. at 344.

[9] The Court of Appeals for the First Circuit has viewed the difference between the definitions of "sale" in these two Acts as insignificant, stating:

"Section 3(a)(14) of the Securities Exchange Act contains neither the 'for value' limitation of Section 2(3) of the Securities

B. The antifraud provisions of the Securities Exchange Act of 1934 were intended to cover fraud in connection with the pledge of securities as collateral for a loan.[10]

1. Because of the generality of the definition of "sale" in the 1934 Act, the primary focus in determining whether a particular transaction constitutes a sale within the meaning of Section 10(b) is not on the definition, but on the broader issue whether Bankers Trust's "alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule" (cf. *Securities and Exchange Commission* v. *National Securities, Inc., supra,* 393 U.S. at 467). In making that inquiry, it must be remembered that "remedial legislation"—into which category "[t]he Securities Exchange Act quite clearly falls"—"should be construed broadly to effectuate its purposes" (*Tcherepnin* v. *Knight, supra,* 389 U.S. at 336).

Act nor the conclusive presumption of value provision. We have no reason to believe that Congress intended, one year after the passage of the Securities Act, to dilute the concept of 'sale' in the Securities Exchange Act. [Citation omitted.] The 'otherwise dispose of' language of Section 3(a)(14) * * * [is] * * * 'hardly limiting.' Thus, the transaction in this case constitutes a sale within Section 3(a)(14) as well as Section 2(3)." *Lawrence* v. *Securities and Exchange Commission*, 398 F.2d 276, 280 (C.A. 1).

[10] The importance of the application of the antifraud provisions of the Securities Exchange Act to pledges is underlined by congressional recognition, in the legislative history of the Securities Acts Amendments of 1975, that pledging of fraudulently-issued, stolen or worthless securities as collateral for loans is a commonly

"A fundamental purpose" of the Securities Exchange Act and of the other federal securities laws was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* * * *." *Securities and Exchange Commission* v. *Capital Gains Research Bureau,* 375 U.S. 180, 186. In that case this Court noted that "Congress intended * * * securities legislation 'enacted for the purpose of avoiding frauds'" to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Id.* at 195 (footnote omitted). And see *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 151.

The requirement of disclosure is no less important when the owner of securities offers them as collateral for a loan than when he offers to dispose of them completely. In both instances the recipient of the securities is induced to part with money in reliance on the alleged value of the securities.

In deciding whether to accept the Equity National stock as collateral for the loan they were making, Mallis and Kupferman had to make the same kind of judgment with respect to the value of that stock that they would have had to make in deciding whether to

---

used method for disposing of such securities. See, Hearings on Organized Crime—Stolen Securities, before the Permanent Subcommittee on Investigations of the Senate Committee on Government Operations, 92d Cong., 1st Sess. 2 (1971); Hearings on Organized Crime—Securities: Thefts and Frauds, before the Permanent Subcommittee on Investigations of the Senate Committee on Government Operations, 93d Cong., 1st Sess. 7 (1973); 121 Cong. Rec. 10733 (1975).

purchase it outright. Although the purpose of evaluating the stock would be different in these two situations, in each instance the basic inquiry was the same: whether the value of the stock warranted committing their capital in reliance thereon. The impact upon Mallis and Kupferman of Bankers Trust's alleged fraud was no less because they accepted the stock as collateral for a loan they gave instead of purchasing it outright.

Mallis and Kupferman certainly would not have made the loan had they known that the collateral designed to secure it was merely worthless paper because the securities the paper purported to represent had been cancelled by the issuer. Mallis and Kupferman were induced to acquire a significant interest in the stock, in return for which they parted with substantial capital, as a result of Bankers Trust's misrepresentation of critical information with respect to the value of the stock. This was precisely the kind of fraud that Congress intended to prohibit in Section 10(b).

Such misrepresentation of a highly significant material fact in connection with the sale of securities repeatedly has been held to constitute fraud under Section 10(b) and Rule 10b–5. *E.g., Mitchell* v. *Texas Gulf Sulphur Company,* 446 F. 2d 90 (C.A. 10), certiorari denied, 404 U.S. 1004; *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath,* 540 F. 2d 27 (C.A. 2); *Zabriskie* v. *Lewis,* 507 F. 2d 546 (C.A. 10). In view of Section 10(b)'s basic purpose of protecting investors (a category which includes lenders)

against fraud, the result should be no different because the "sale" of securities in connection with which the fraud was committed took the form of a pledge rather than a more permanent disposition.

As the Court of Appeals for the Second Circuit explained in *United States* v. *Gentile,* 530 F. 2d 461, 467, certiorari denied, 426 U.S. 936, in holding that a pledge of securities was a sale under the Securities Act of 1933:

> In effect, the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as the indisputable basis for statutory regulation of securities transactions. We therefore find no reason to treat the equivalent risks differently under the statute.

Amicus Clearing House argues (Br. 12), however, that a pledgee does not assume the type of investment risk of an outright purchaser of securities. It contends that a pledgee has "recourse against all the pledgor's assets" and "his risk from depreciation [in the value of the pledged securities] does not affect the right to repayment but is merely one of numerous factors, the most important of which is the pledgor's overall financial condition, which affect the ease of repayment."

These circumstances, however, do not eliminate the pledgee's investment risk with respect to the securities. Although the degree of that risk may vary with the particular pledgor's financial condition, the

risk exists in every case. Since it is commonplace in the commercial world that substantial loans frequently are made without collateral, the very fact that the lender does require security shows that in the particular transaction the lender may be relying upon the collateral as protection for his loan. The argument that the pledgee has the right to seek repayment from the pledgor's other assets ignores the very purpose of collateral—to enable the lender to obtain repayment of the loan in the event of the borrower's default without having to look to the borrower's other assets.

In this case Mallis and Kupferman presumably were aware that Arnold's and Fowler's credit ratings were poor, since Arnold told Mallis that he would pay a $50,000 finder's fee for a loan of $156,000 (App. 16–17). In these circumstances, the fact that Arnold and Fowler offered them the Equity National stock as collateral must have induced Mallis and Kupferman to make the loan.[11]

[11] The court of appeals, in addition to holding that Mallis and Kupferman "were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler," stated that Bankers Trust was "a seller by virtue of its release" of the securities the Kateses had pledged (App. 165). The latter conclusion was unnecessary to the court's decision, since if Mallis and Kupferman were "purchasers," Bankers Trust's status as a seller *vel non* is irrelevant. A defrauded purchaser has a cause of action under Rule 10b–5 against "any person" who committed fraud "in connection with the purchase," regardless of whether that person is the seller. *E.g.*, *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F. 2d 963, 968 (C.A. 2). In *Heit* v. *Weitzen*, 402 F. 2d 909 (C.A. 2), certiorari denied, 395 U.S. 903, the plaintiff purchasers alleged that the defendant corporate officials had made material misstatements in the

2. Bankers Trust argues (Br. 14) that because "[b]oth at common law and under the Uniform Commercial Code, a 'pledge' of securities is not a 'purchase' or 'sale' * * * ," it should not be treated as a sale under the antifraud provisions of the federal securities law. But even if pledges were not sales under state law—which we dispute below—that would not preclude their being sales under the antifraud provisions of the federal securities laws. If "there [is] a 'sale' of a security and * * * fraud [is] used 'in connection with' it, there is redress under §10(b), whatever might be available as a remedy under state law." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12. As the Court of Appeals for the Seventh Circuit pointed out in *Dasho* v. *Susquehanna Corp.*, 380 F. 2d 262, 266, certiorari denied *sub nom. Bard* v. *Dasho*, 389 U.S. 977, in discussing the definitions of purchase and sale in the Securities Exchange Act:

> This broad language indicates an intention by Congress that the words "purchase" and "sale" are not limited to transactions ordinarily gov-

company's annual report, thus inflating the market price of its shares. The plaintiffs purchased their securities on the market and not from the defendants. The court of appeals held that the plaintiffs had alleged a cause of action under Rule 10b-5. It stated: "It is reasonable to assume that investors may very well rely on the material contained in false corporate financial statements which have been disseminated in the market place, and in so relying may subsequently purchase securities of the corporation." 402 F. 2d at 913. Consequently, Bankers Trust's argument (Br. 27–33) that is was not a "seller" for purposes of Rule 10b–5 is beside the point.

erned by the commercial law of sales. The purpose is evidently to make control of securities transactions reasonably complete and effective to accomplish the purposes of the legislation."[12]

In accord with this congressional intent, the terms "purchase" and "sale" have been held to cover a variety of transactions in securities cases, without regard to whether state law so characterized them. These include mergers,[13] issuance of stock,[14] forced sales,[15]

[12] Similarly, other courts have emphasized that the definition of "sale" must be construed liberally for purposes of the antifraud provisions. See, *e.g.*, *Spector* v. *L Q Motor Inns, Inc.*, 517 F.2d 278, 286 (C.A. 5), certiorari denied, 423 U.S. 1055; *Coffee* v. *Permian Corp.*, 434 F. 2d 383, 385 (C.A. 5), certiorari denied, 412 U.S. 920; *Herpich* v. *Wallace*, 430 F. 2d 792 (C.A. 5); *Knauff* v. *Utah Construction & Mining Co.*, 408 F.2d 958, 961 (C.A. 10), certiorari denied, 396 U.S. 831; *Mader* v. *Armel*, 402 F.2d 158, 160 (C.A. 6), certiorari denied *sub nom. Young* v. *Mader*, 394 U.S. 930; *Lawrence* v. *Securities and Exchange Commission*, *supra*, 398 F.2d at 280.

[13] *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*; *Smallwood* v. *Pearl Brewing Co.*, 489 F. 2d 579, 591 (C.A. 5), certiorari denied, 419 U.S. 873; *Vine* v. *Beneficial Finance Co.*, 374 F. 2d 627, 634 (C.A. 2), certiorari denied, 389 U.S. 970; *Dasho* v. *Susquehanna Corp.*, *supra*.

[14] *Schoenbaum* v. *Firstbrook*, 405 F. 2d 215, 219 (C.A. 2), certiorari denied *sub nom. Manley* v. *Schoenbaum*, 395 U.S. 906; *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 202–203 (C.A. 5), certiorari denied, 365 U.S. 814.

[15] *Travis* v. *Anthes Imperial Ltd.*, 473 F. 2d 515, 522 (C.A. 8); *Crane Company* v. *Westinghouse Air Brake Company*, 419 F. 2d 787, 794 (C.A. 2), certiorari denied, 400 U.S. 822; *Vine* v. *Beneficial Finance Co.*, *supra*, 374 F.2d at 635.

and exchanges of shares."[16] This Court, in *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*, rejected the contention that a fraudulently-induced merger did not involve a purchase or sale of securities by the defrauded shareholders, stating:

> The broad antifraud purposes of * * * [Section 10(b)] and * * * [Rule 10b–5] would clearly be furthered by their application to this type of situation. Therefore we conclude that Producers' shareholders "purchased" shares in the new company by exchanging them for their old stock. As the Court of Appeals for the Seventh Circuit has said, "This view does no violence to the statutory language, and is the present interpretation of the body which is responsible for the administration of the acts."

393 U.S. at 467–468, citing *Dasho* v. *Susquehanna Corp.*, *supra*.

In any event, Bankers Trust errs in contending that a pledge is not a sale under either the Uniform Commercial Code or other state law. The definition of Official Draft 1952) specifically includes a "pledge" (Section 1–201(32)). Section 3–302(4) of the Code gives the rights of a holder in due course to the purchaser of a limited interest—such as the interest of "a

[16] *Swanson* v. *American Consumer Industries, Inc.*, 415 F. 2d 1326, 1330 (C.A. 7); *Knauff* v. *Utah Construction & Mining Co.*, *supra*, 408 F. 2d at 961.

"purchase" in the Uniform
Commercial Code (A.L.I.

pledgee in a security transaction" (see Comment 5 to Section 3-302)—to the extent of the interest purchased."

Moreover, a pledge has been held to be a "sale" under a state blue sky law designed to prevent fraud in securities transactions. In 1932, prior to the enactment of the federal securities laws, the Court of Appeals for the Ninth Circuit, in *Cecil B. De Mille Productions* v. *Woolery*, 61 F. 2d 45, held that an assignment of royalty interests in oil and gas leases as collateral for a loan was a "sale" within the meaning of the California Corporate Securities Act, which

[17] The Clearing House asserts (Br. 3, 15) that there is an "internal contradiction" in the court of appeals' opinion, because the court, while holding Mallis and Kupferman to be purchasers for purposes of Section 10(b) and Rule 10b-5, stated (App. 161) that they were not "purchasing" stock "within the meaning of Regulation U." But the question before the court under Regulation U—which prohibits banks from extending credit in excess of the value of collateral to purchase stock on margin—was not whether Mallis and Kupferman were "purchasing." The court was dealing with the claim by Mallis and Kupferman that Franklin National Bank had extended credit to them in violation of Regulation U. But where the bank's customer does not pledge stock with the bank, that regulation is applicable only if the customer is "engaged principally, or as one of [his] important activities, in the business of extending credit for the purpose of purchasing or carrying margin stocks * * *." 12 C.F.R. 221.3(q). The court of appeals stated (App. 161):

"Since borrowing for the purpose of relending to enable others to purchase or carry margin stock was not one of [Mallis' and Kupferman's] 'important activities,' we hold that Regulation U does not apply to the Franklin National Loan."

That ruling is unrelated to the question whether Mallis and Kupferman were "purchasers" of the Equity National stock.

defined the term "sale" as including "every disposition, or attempt to dispose, of a security or interest in a security for value" (see 61 F. 2d at 50)—a definition almost identical to that contained in the Securities Act of 1933 (see pp. 12–13, *supra*). The court ruled that, since a pledgee has an "'interest in the thing pledged,'" it was "obvious" that the pledgor "'disposed' or attempted to dispose, of an 'interest in a security'" when it pledged securities as collateral for a loan. 61 F. 2d at 50. In enacting the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress intended to expand the protection state blue sky laws gave to investors. See S. Rep. No. 47, 73d Cong., 1st Sess., p. 2 (1933).

3. In view of the foregoing principles and considerations, it is not surprising that the federal courts repeatedly have held that a pledge of securities is a sale under both the Securities Exchange Act of 1934 and the Securities Act of 1933. In *Securities and Exchange Commission* v. *Dolnick*, 501 F. 2d 1279 (C.A. 7), Dolnick had pledged stock of two corporations—Pig'N Whistle and another—as collateral for a bank loan, and "to secure" the loan had made false representations to the bank concerning the stock. The court held (*id.* at 1283) that these statements were "made in connection with the pledges of the stock of both corporations in a single transaction," and "they were in connection with the sale of Pig'N Whistle stock and therefore part of the violation of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) alleged in the complaint."

Similarly, in *United States* v. *Gentile,* 530 F. 2d 461 (C.A. 2), discussed *supra,* p. 17, the court upheld a criminal conviction for violating the antifraud provisions of the Securities Act of 1933, based upon the pledging with banks, as collateral for loans, of stock certificates on which the names of unauthorized persons had been written. The court ruled that the pledges were "sales" of securities under Section 17(a) of the Act, which prohibits fraud "in the offer or sale" of securities. In *Securities and Exchange Commission* v. *Dolnick, supra,* the court also held, as did the court in *American Bank & Trust Company* v. *Joste,* 323 F. Supp. 843 (W.D. La.), that a pledge of securities as collateral for a loan was a sale under both the antifraud and the securities registration provisions of the 1933 Act. Other cases have held that the acceptance by the lender of a pledge of securities as collateral was a "purchase" of the securities under the 1933 Act for purposes of the registration requirements of that Act.[18] *Securities and Exchange Commission* v. *Guild Films Co.,* 279 F. 2d 485 (C.A. 2), certiorari denied *sub nom. Santa Monica Bank* v.

[18] Those cases involved the question whether the lender was required to comply with the registration provisions, with respect to securities it had acquired as collateral, when it foreclosed on the collateral by selling the securities. The answer depended upon whether, by acquiring the collateral, the bank had "purchased from an issuer with a view to * * * the distribution of any security," which would have made it a statutory underwriter under Section 2(11) of the 1933 Act, 15 U.S.C. 77b(11), and thus ineligible for an exemption from the registration requirements in Section 4(1), 15 U.S.C. 77d(1).

Securities and Exchange Commission, 364 U.S. 819;[19] *Securities and Exchange Commission* v. *National Bankers Life Insurance Co.,* 334 F. Supp. 444, 456 (N.D. Tex.), affirmed, 477 F. 2d 920 (C.A. 5); cf. *Securities and Exchange Commission* v. *International Chemical Development Corp.,* 469 F. 2d 20 (C.A. 10).

McClure v. *First National Bank of Lubbock, Texas,* 497 F. 2d 490 (C.A. 5), certiorari denied, 420 U.S. 930, held that in the particular circumstances of that case a pledge of stock was not a sale of securities under Section 10(b) of the 1934 Act and Rule 10b–5. McClure had pledged her stock as collateral for a bank's renewal of a loan to a corporation which she and her ex-husband owned. She alleged that her consent to the original loan had been obtained through the representation that the corporation needed the money, but that her ex-husband used the money for personal purposes. The bank eventually foreclosed on the corporation's property, thus making the plaintiff's stock worthless. The court of appeals held that the plaintiff had not alleged a violation of the Act or the Rule.

The court did "not doubt that a pledge of securities can constitute a 'sale' in some cases," but con-

[19] Beginning with its submission in *Guild Films* the Commission repeatedly and consistently has argued that a pledge is a sale under both the 1934 and the 1933 Acts. Although Bankers Trust asserts (Br. 25) that the Commission "changed its position" in *Guild Films,* prior to that time "there had been no public pronouncement by the Commission" on the subject. 1 Loss, *Securities Regulation* 645 (2d ed. 1961).

cluded that "the pledge was not a sale in the circumstances of this case" (497 F. 2d at 495). The court stated (*ibid.*):

> A commercial bank in accepting a pledge of stock as additional consideration for the extension of an overdue commercial loan does not necessarily affect the securities industry. * * * If the bank sells stock pledged as loan collateral, it might then be subjected to liability in connection with the sale if it does not meet the requirements of the anti-fraud provisions of the securities acts, but mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not, of itself bring within the scope of the federal securities acts a transaction otherwise outside their purview.

The court also ruled that because the bank had not foreclosed on the pledged stock or sold it, the pledge did not constitute a "sale."

That ruling involved two errors:

(1) The scope of Section 10(b) is not limited to "'preserving the integrity of the securities markets,'" and "the fact that the transaction is not conducted through a securities exchange or an organized over-the-counter market is irrelevant to [the Act's] coverage * * *." *Superintendent of Insurance* v. *Bankers Life & Casualty Co., supra,* 404 U.S. at 10, 12. Section 10(b) applies "even though the transaction is conducted directly between the buyer and seller" (*Hooper* v. *Mountain States Securities Corp.,* 282 F. 2d 195, 201 (C.A. 5), certiorari denied, 365 U.S. 814).

(2) It is irrelevant that the bank did not foreclose on the collateral. The critical question is what happened when the pledge was made, which was when the fraud took place, and not what happened later. The court of appeals in *Gentile* criticized this aspect of the *McClure* decision. 530 F. 2d at 467, n. 6.[20]

Moreover, for the reasons previously set forth in this brief, *McClure* is wrong because it fails to give sufficient weight to the language of the definitional provisions of the 1934 and 1933 Acts, and to the policy considerations indicating that a pledge of securities as collateral for a loan is a sale under the antifraud provisions of those Acts.[21]

4. Bankers Trust (Br. 31) and *amicus* Clearing House (Br. 8) argue that Congress did not intend the

---

[20] Two district courts in the Second Circuit, relying on the same rationale as was used in *McClure*, held that a pledge was not a sale under Section 10(b) and Rule 10b-5. *Investment Properties International, Ltd.* v. *I.O.S., Ltd.*, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,011, p. 90,740 (S.D. N.Y.), and *Rosen* v. *Dick*, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,786, p. 96,605 (S.D. N.Y.). These cases are of dubious vitality in view of the Second Circuit's subsequent decision in *Gentile*.

[21] Bankers Trust, citing Commission Rule 16a-6 under the Securities Exchange Act, 17 C.F.R. 240.16a-6, erroneously asserts that the rules under that Act "recognize that a pledge of securities is not a sale" (Br. 24; see also Clearing House Br. 7). Rule 16a-6 provides that an insider's granting, acquisition or disposal of any "put, call, option or other right or obligation" to buy or sell securities is a change in beneficial ownership and must be reported under Section 16(a) of the Act. A note to that Rule provides that the right to sell securities pledged as collateral need not be reported (though any sale itself must be). The Rule deals with changes in beneficial ownership that must be reported. It does not address the question of whether a pledge is a sale and is unrelated to the coverage of the antifraud provisions.

Securities Exchange Act to substitute federal for state law in cases involving misrepresentation constituting fraud in connection with the pledge of securities as collateral for a loan. But the application of federal antifraud provisions here would in no way preempt or conflict with state law. Bankers Trust attempts (Br. 31–32) to analogize this case to *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, which held that a majority stockholder's effectuation of a short-form merger pursuant to Delaware law, designed to eliminate minority interests and done in alleged breach of the stockholder's fiduciary duty, did not violate Rule 10b–5.

In that case, unlike the present one, the fraud alleged was "neither deceptive nor manipulative" (430 U.S. at 474), but was instead "a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure"—a typical case of "corporate mismanagement * * * in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary" (*id.* at 476–477). The Court concluded that Rule 10b–5 does not extend to mere "internal corporate mismanagement" (*id.* at 479, quoting from *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6, 12).

The present case, however, does not involve charges of corporate mismanagement or a majority stockholder's unfair treatment of minority ones. Instead, it charges only a garden variety type of fraud, based

upon a misrepresentation of the type that courts traditionally have resolved. See *supra,* p. 16, *infra,* p. 34.

A holding that a pledge of securities is a sale under Section 10(b) and Rule 10b–5 would not subject the federal courts to "a plethora of litigation * * * when the loan goes bad and the debtor has pledged securities which are either sold or diminished in value as a result of shifts in the stock market," as Bankers Trust predicts (Br. 32). As we have shown (*supra,* pp. 23–25), there is substantial case authority that a pledge is a sale under both the 1934 and the 1933 Acts, but these decisions have not produced the litigation that Bankers Trust anticipates.

Moreover, before a pledgee could recover under Rule 10b–5, he would have to establish all the elements of the offense—including the misstatement or nondisclosure [22] or other fraudulent conduct, its materiality and the defendant's *scienter* (*Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185)—and also a causal connection between the defendant's misconduct and the plaintiff's injury. This Court's recognition that a pledgee is a purchaser would only give a pledgee standing to maintain a suit. It would not create the likelihood of widespread litigation against, or liability of, pledgors accused of fraud in connection with the pledging of securities as collateral. See, *e.g., Dopp* v. *Franklin National Bank,* 374 F. Supp. 904 (S.D. N.Y.) (pledgor

[22] At this stage of the litigation the question does not arise whether mere silence by Bankers Trust would be actionable under the Act and the Rule in the circumstances of this case. See note 4, *supra.*

had standing as seller of securities to sue under Section 10(b), but failed to state a claim on which relief could be granted); and see the discussion in Part C, *infra*.

5. Bankers Trust also argues that "Congress provided that banks were to be regulated *not* by the Securities Exchange Commission [*sic*], but by the Federal Reserve Board" (Br. 31), and it points to this Court's statement that the 1934 Act "'was enacted primarily to halt securities fraud, not to regulate banks'" (Br. 30, citing *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148, 157)." But the fact that the defendant in this case is a bank is fortuitous. The critical question is whether a pledge of securities as collateral for a loan is a sale under the antifraud provisions, not the identity of the person who allegedly committed the fraud. Furthermore, although banks probably are the most common pledgees in commercial transactions, other persons also receive pledges as collateral, as in the instant case, where the pledgees, Mallis and Kupferman, are individuals.

C. The holding of the court of appeals that a pledge is a sale is not inconsistent with Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723.

In *Blue Chip*, this Court held that the plaintiff, who had refrained from purchasing stock in alleged re-

[23] Bankers Trust's statement that "banks were specifically exempted from any provisions of the securities laws" (Br. 30) is erroneous. Securities issued by banks are exempt from the registration requirements of the Securities Act (Section 3(a)(2), 15 U.S.C. 77c(a)(2)), but not from that Act's antifraud provisions. See Section 17(c), 15 U.S.C. 77q(c).

liance upon misrepresentations by the offeror, had no standing to maintain an action for damages for violation of Section 10(b) and Rule 10b-5, because the plaintiff had not made a "purchase or sale" of securities. The Court ruled that only "actual purchasers and sellers of securities" could bring such an action (421 U.S. at 730, 731–732, 749). The Court stated that it was not dealing with a statute that "legislated the elements of a private cause of action for damages" (*id.* at 748), but with a judicially-created private right of action, which "will have to be judicially delimited one way or another unless and until Congress addresses the question." *Id.* at 749.

As the court of appeals pointed out in this case (App. 164), *Blue Chip* involved "a plaintiff who claimed that the defendant's misrepresentations caused it to refrain from purchasing securities." The gravamen of the plaintiff's complaint in *Blue Chip* was that it had refrained from acting. In the present case, on the other hand, Mallis' and Kupferman's complaint is exactly the opposite. They contend that Bankers Trust's fraud induced them to take affirmative action—to make a substantial loan—which they would not otherwise have taken.

The major considerations that led the Court in *Blue Chip* to limit the private right of action under Section 10(b) and Rule 10b-5 to actual buyers and sellers do not apply in this case. If, as we urge, a

pledge of securities as collateral for a loan is a "sale", there is no question that Mallis and Kupferman were purchasers of securities, that Arnold and Fowler (the pledgors) were sellers, and that Bankers Trust's misrepresentation was committed in connection with the sale. Moreover, in this case the Court will be determining the meaning of the statutory terms "purchase or sale of securities"—a determination which will affect the ability of the government and private persons alike to bring an action at all—rather than delimiting the contours of a judicially-created private right of action, as it did in *Blue Chip*.

The principal policy consideration the Court stressed in *Blue Chip* was the "danger of vexatiousness" if non-purchasers and non-sellers were permitted to maintain suits under Rule 10b–5 (421 U.S. at 739). It noted that "[t]he potential for possible abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure may likewise exist in this type of case to a greater extent than they do in other litigation" (*id.* at 741); that in a suit based on the claim that the plaintiff had refrained from buying or selling securities, the outcome "will turn largely on which oral version of a series of occurrences the jury may decide to credit, and therefore no matter how improbable the allegations of the plaintiff, the case will be virtually impossible to dispose of prior to trial other than by settlement" (*id.* at 742); that the rule limiting plaintiffs to actual purchasers or sellers "separates in a readily demonstrable manner the group of plaintiffs who actually purchased or actually sold, and whose version of the

facts is therefore more likely to be believed by the trier of fact, from the vastly larger world of potential plaintiffs who might successfully allege a claim but could seldom succeed in proving it" (*id.* at 743) and "limits the class of plaintiffs to those who have at least dealt in the security to which the prospectus, representation, or omission relates" (*id.* at 747). It pointed out that "dealing in the security [by actual purchasers or sellers], whether by way of purchase or sale, will generally be an objectively demonstrable fact in an area of the law otherwise very much dependent upon oral testimony" (*ibid.*), whereas "bystanders to the securities marketing process could await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused nonselling in a falling market and that unduly pessimistic predictions by the issuer followed by a rising market caused them to allow retrospectively golden opportunities to pass" (*ibid.*).

These considerations are inapplicable where the fraud relates to the value of a security that has been pledged as collateral for a loan. The fact of the pledge ordinarily is demonstrable by objective evidence; pledges in a commercial situation usually are as well documented as outright purchases and sales. A pledgee who has been induced to make a loan through misrepresentation concerning the value of the pledged securities is not a mere bystander but has "dealt in the security to which the • • • representation, or omission relates" (421 U.S. at 747). Permitting him to sue would not create the danger of a large number of

strike suits in which possible liability would turn on the jury's assessment of the plaintiff's claim that he had refrained from acting.

The factual issues in this case are of the type that courts and juries customarily have been deciding in fraud cases for years: whether Bankers Trust knew that the Equity National stock was worthless, whether it misrepresented that fact to Mallis and Kupferman, and whether that conduct influenced them to accept the pledge as collateral for the loan. This case does not present the dangers and problems that led the Court in *Blue Chip* to limit suits under Rule 10b–5 to actual purchasers and sellers. *Blue Chip* thus suggests no reason to construe a pledge as anything other than a sale, and, if it is so construed, Mallis and Kupferman were actual purchasers of the stock because they received it as collateral for the loan they made.[24]

[24] The Court in *Blue Chip* also pointed out (421 U.S. at 734–735) that actual purchasers and sellers will "at least seek to base recovery on a demonstrable number of shares traded. In contrast, a putative plaintiff, who neither purchases nor sells securities but sues instead for intangible economic injury such as loss of a non-contractual opportunity to buy or sell, is more likely to be seeking a largely conjectural and speculative recovery in which the number of shares involved will depend on the plaintiff's subjective hypothesis." That consideration also is inapplicable here, since there is no question concerning the number of shares pledged or the amount of the loss that Mallis and Kupferman suffered.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

WADE H. MCCREE, JR.,
Solicitor General.

HARVEY L. PITT,
General Counsel,
PAUL GONSON,
Associate General Counsel,
JACOB H. STILLMAN,
Principal Assistant General Counsel,
JAMES E. BOWERS,
Special Counsel,
SUE E. AUERBACH,
Attorney,
Securities and Exchange Commission.

NOVEMBER 1977.

U.S. GOVERNMENT PRINTING OFFICE: 1977